Tax Loss Harvesting

Executive Summary

Investors rightfully care most about net return, that is profit after cost and tax. An important tool to ensure tax-efficiency is TAX LOSS HARVESTING.

Tax Loss Harvesting is the strategic selling of positions at loss to offset already realized or potential future profits with the intention to reduce capital gains tax.

Herges Capital is predestined to execute a particularly effective tax loss harvesting for clients. Typically, resulting in zero capital gains tax year in year out. That is because the firm applies direct indexing, buying directly numerous individual stocks and bonds. This highly granular investment approach provides ample substitution investments necessary to harvest losses.

Client Q&As

How can you make it tax-free? I thought all gains are subject to 25% tax?
Capital gains tax is only paid on REALIZED profits, i.e. when selling with a price gain. But you may OFF-SET those with realized losses in other positions. Overall, if done correctly and strategically, you indeed may end up not paying capital gains tax.

The capital gains tax rate itself will depend on your personal regular income bracket and how long you held the liquidated positions. As of 2019, there is no 25% capital gains tax bracket anymore. For short-term gains the capital gains tax rates are 10%, 12%, 22%, 24%, 32%, 35% and 37%. For long-term gains (more than one year) there are only three tax rates: 0%, 15% and 20%. The long-term capital gains rates are lower to encourage people to invest long-term.

Does no capital gains tax not in turn mean one made no profit at all?
No, the capital gains tax payments and portfolio performance are unrelated. Only realized profits trigger tax events. Your portfolio might have a stellar performance (on paper) and still, you may not be subject to capital gains tax. And the other way around, even if you pay capital gains tax, still, your total portfolio could be down substantially.

Is the capital gains tax payment not only postponed?
Right, every position will sooner or later be liquidated. And yes, if you allow massive profits to accumulate over years or even decades then you might not have, at that very moment, the corresponding off-setting losses to compensate with. In that scenario, you would then have to pay long-term capital gains tax.

However, the preferable alternative is to NOT ALLOW those massive tax-relevant gains to develop in the first place. Instead, one realizes them prior in a tax-neutral way through tax loss harvesting. It is important to recognize it is not enough to just bring the capital gains tax to zero in any given year. In a forward-looking approach one also has to ACTIVELY REDUCE FUTURE TAX LIABILITIES. In other words, a hugely profitable position is a threat, too. And has to be dealt with early.

I am in a very low tax bracket, is tax loss harvesting still relevant to me?
Naturally, tax-efficient investing is more important to tax-paying investors. But every tax payment saved is your net gain. That holds true even if you are in the lowest 10% short-term capital gains tax bracket.

But yes, if

- you hold positions always beyond a year and
- qualify for the 0% long-term capital gains rate and
- stay in that 0% bracket not only now but also in the future

then you can do without active tax loss harvesting. Not many investors will match or will want to match the above criteria.

Doesn't tax loss harvesting lead to higher trading activities and cost?
True, in order to reach the no-capital-gains-tax goal now and in years ahead the investor will have to execute additional trades during the year. It is also more work to analyze and continuously monitor the tax situation. But the improved after-tax return clearly out-weights those additional cost and time spent.

Can you guarantee to avoid capital gain tax?
No, paying no capital gains tax should not be guaranteed. There are theoretical scenarios in which tax loss harvesting is fruitless.

Say ALL POSITIONS in your portfolio gain. In that case, harvestable losses would just not exist. Should then a portfolio re-structuring be necessary, because the gains were highly unevenly distributed or cash to withdraw is needed, then indeed a sale might possibly lead to capital gains tax. Though, there is still a chance that before the year-end deadline new sources of losses would emerge.

In the aforementioned all-up scenario, one would at least aim to avoid short-term capital gain tax and only trade positions subject to the lower long-term capital gain tax.

But in a diversified portfolio, by definition, asset prices will not all move in tandem. Therefore, in reality, one can EXPECT to avoid paying capital gains tax when the portfolio is sufficiently diversified and spread over various positions (high granularity). So far, Herges Capital clients always avoided capital gains tax.

The Importance of Substitute Investments

It is great to save taxes. But a portfolio's composition and corresponding risk profile make or break the success of an investment, not tax payments. Investors' portfolio asset allocations match their preferences. Those might be even stated in a signed Statement of Investment Policies (SIP). A portfolio shall not change its overall profile, not even for a short period, just to reduce tax payments.

When considering harvesting a loss one has to fully SUBSTITUTE that position in order to maintain the targeted total risk profile. That new position, replacing the old one, has to have an as similar risk profile as possible to the original one. It is insufficient to just sell a stock position for tax reasons and then keep the proceeds in cash. That transaction would change the overall portfolio structure (here: an undesirable lower stock risk).
Same holds true for selling a profitable position, so not to let gains accumulate to a future tax burden. This one typically has to be substituted, too.

The challenge is to identify substitute investments for most of the open portfolio positions without violating the wash-sale rule.

Wash-Sale Rule

The Internal Revenue Service (IRA) would disallow a tax deduction if the SAME or SUBSTANTIALLY IDENTICAL asset would be traded 30 days before or after the sale. Resulting in a total 61-day wash-sale time interval.

The wash-sale rule demands a genuine alternative investment when purposely selling at a loss. It is not practical to re-purchase immediately the identical stock just sold. It is likewise not practical to re-purchase another index-tracking Exchange-Traded Fund (ETF) linked to the identical underlying index.
But another stock, from another company, is a viable substitution.

The Benefit of Portfolio Granularity

The granularity of a diversified portfolio is determined by the number of different holdings, i.e. how many individual pieces make up the whole.

Take the U.S. stock market as an example. That investment segment can be represented by

- one index ETF or holding
- 11 sector ETFs or purchasing
- 20-25 carefully-selected individual stocks.

Those are all diversified investments into the U.S. stock market.

However, from a tax loss harvesting perspective, the one index ETF option (say, Dow Jones 30, S&P 500 or Russell 2000) is the least granular way to get exposure. Only one portfolio position greatly reduces loss opportunities. If that one ETF position is in the plus, no losses exist. Consequently, nothing to harvest. If it is in the minus, you may indeed sell it and replace it temporarily by an ETF on a different stock index. So not to violate the wash-sale rule. And then later switch back.

Holding instead the 11 sector ETFs increases the chances that one or more of those positions are exploitable for tax losses. See table 1 for those sector ETFs.

Sector	Ticker
Consumer Discretionary	XLY
Industrials	XLI
Consumer Staples	XLP
Health Care	XLV
Communication Services	XLC
Information Technology	XLK
Energy	XLE
Financials	XLF
Materials	XLB
Utilities	XLU
Real Estate	XLRE

Table 1: Standard & Poor's Depositary Receipt (SPDR) sector ETFs

Because stock sectors are far from being perfectly correlated. More variety means that even though the 11 sector ETFs might be in the plus overall, still some of them might well be in the minus. The profit and loss landscape is not as binary as with just one index ETF position only.

Finally, 20-25 individual stock positions instead of the previous 11 sector ETFs adds even more tax loss harvesting opportunities. Substantially more portfolio positions are available. Again, even if the sum of all those individual stock positions is profitable, some positions are likely to be in the minus. Those will be exploitable to reduce capital gain tax.

The more granular a portfolio, the more opportunities exist for tax loss harvesting and consequently zero capital gains tax. See chart 1.

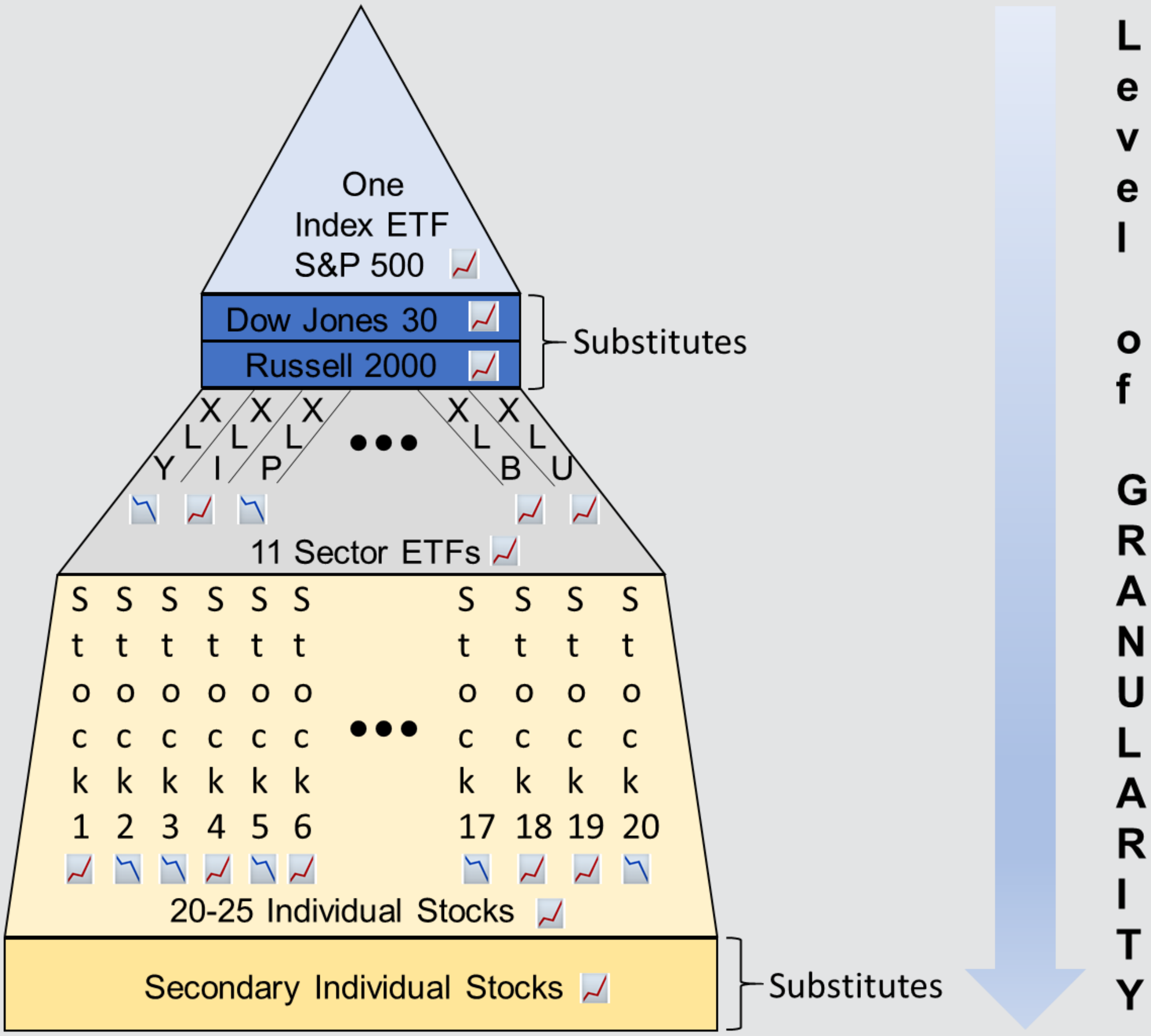

Chart 1: Levels of granularity in a U.S. stock market investment.
More positions offer increases possibilities to apply tax loss harvesting

Direct Indexing and Tax Loss Harvesting are Best Friends

An often-observed standard diversified portfolio consists of

- a domestic stock ETF
- an international stock ETF
- a domestic bond ETF
- an international bond ETF plus
- some cash.

Say, target allocation is the fairly common 65% in stocks, 35% in bonds and cash. What are the chances to apply tax loss harvesting and avoid capital gains tax?

When the stock ETFs increase in value, at some point one has to rebalance and sell some in order to keep the desired 65/35 allocation. There will be no opportunity to offset those gains with losses from another sale. A tax event is unavoidable. Likewise when stocks tumble, and the bond ETFs perform instead. At some point, more stock ETFs will have to be bought to keep the original allocation. Yet again, selling the profitable bond ETFs cannot be compensated by corresponding loss trades. Tax payment will be due.
Above described standard portfolio, typically offered by Robo-Advisors and online brokers has little chance to be tax-efficient because the number of positions is too low. In this case, only two stock-related positions offer insufficient granularity from a tax-saving point of view.

Compare with a typical Herges Capital portfolio. The firm is investing directly in carefully-selected individual stocks and bonds (so-called direct indexing).

A U.S.-based Herges Capital investor client holds a diversified and highly granular portfolio of about 27 individual Northern American stocks plus 2-3 international stock ETFs plus 14 commodity ETFs plus one real-estate ETF plus one inflation-linked ETFs and more. In total, every investor holds nearly 50 positions. Obviously ample opportunities to offset gains with losses, while still preserving the desired individual asset allocation.

Tax loss harvesting is particularly effective when combined with our direct indexing approach. 27 individual stock positions distributed over various sectors makes it far more likely to find losses within that domestic stock allocation to off-set gains within the same segment. Ultimately resulting in overall tax-neutral investment. There are just so many more control levers available to operate. Compare to the one and only control lever (the one domestic stock ETF) in the previous example.

As mentioned earlier, when liquidating a position, it is mandatory to replace it with a suitable substitution. Replacing one individual stock with a similar, highly-correlated alternative is the proprietary added value of an experienced investment advisor. At Herges Capital we continuously monitor a universe of stocks in order to timely exploit tax loss harvesting opportunities. Tax-efficiency is on our agenda not only in December, the most popular time for that strategy but throughout the whole year.

Example

Say AutoZone (ticker AZO) generated heavy losses that are worth harvesting. Then we would require a new name representing the 'Consumer Discretionary' stock sector. We certainly do not neglect or under-weight that sector only to save some tax dollars. O'Reilly (ticker ORLY) is not only one of AutoZone's direct competitors, but more importantly, it offers a similar earnings pattern. We would then realize the AutoZone loss and simultaneously initiate a new position in O'Reilly. Switching back after the wash-sale 30 days period has passed. O'Reilly substitutes our primary choice AutoZone for a short period for the benefit of higher after-tax returns.

This is a straightforward example. Not every company will have a suitable direct competitor. But each name in our stock portfolio can be replaced temporarily by a secondary selection (see chart 1) offering a sufficiently-similar risk profile.

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